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Supreme Court, U.S.
FILED

961938 JUN 4 1997

No. OFFICE OF THE CLERK

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM 1996

IN RE: BAKER & GETTY FINANCIAL SERVICES, INC.,
Debtor,

WESBANCO BANK BARNESVILLE,
formerly known as The First National Bank of Barnesville,
Petitioner,

v.

CARL D. RAFOTH, Trustee

CUSTOMER CREDITORS,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

I. Whether the Sixth Circuit Court of Appeals committed legal error in ordering that the debtors' estate be liquidated pursuant to the stockbroker liquidation provisions of the Bankruptcy Code when the debtors admittedly were operating a "Ponzi Scheme", where the debtors were never engaged in securities transactions, and where the debtors do not satisfy the statutory definition of a stockbroker found in 11 U.S.C. § 101(53A).

II. Whether the Sixth Circuit Court of Appeals can consider the conduct and the separate transactions of an entity that is neither a debtor nor a creditor in the bankruptcy case for the purpose of attributing that entity's conduct as being the conduct of the debtors, and thereby directing a stockbroker liquidation in a bankruptcy proceeding in which there were neither securities transactions nor commingled securities for distribution.

PARTIES TO THE PROCEEDINGS

The petitioner in this action is WesBanco Bank Barnesville (hereinafter "WesBanco"), formerly known as The First National Bank of Barnesville. WesBanco, Inc. is a publicly traded company and is the parent corporation of WesBanco. The respondents are James J. Baker, Lois Baker, Darrell A. Brown, Guy Brown, Rhea Caldwell, Dale L. Christman, Eldon Christy, John Jorris, Donald E. Lafferre, P. E. Ludwig, Richard Oehler, David Rubel, Gary A. Rubel, Thomas Stubbs, John G. Weber, Steve Weber and Rodney C. Wilson. The individual respondents are referred to in the caption of the case as the "customer creditors" and are referred to in this petition as either the "respondents" or the "customer creditors".

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PETITION FOR A WRIT OF CERTIORARI

WesBanco Bank Barnesville petitions for a writ of certiorari to review the March 7,1997 order of the United States Court of Appeals for the Sixth Circuit denying WesBanco's petition for rehearing (App. A, A1) and the February 12, 1997 judgment and opinion of the United States Court of Appeals for the Sixth Circuit (App. B, A3 and App. C, A6). The opinions of the United States Court of Appeals for the Sixth Circuit (App. C, A6), the United States District Court for the Northern District of Ohio, Eastern Division (App. E, A27), and the United States Bankruptcy Court, Northern District of Ohio, Eastern Division (App. F A37) are unreported and are reproduced in the Appendix to this Petition.

STATEMENT OF JURISDICTION

This petition seeks review of an order and opinion entered by the United States Court of Appeals for the Sixth Circuit on February 12, 1997 (App. B & C). Petitioner, WesBanco filed a Petition for Rehearing on February 26, 1997 which the United States Court of Appeals for the Sixth Circuit denied on March 7, 1997 (App. A).

Petitioner WesBanco Bank Barnesville seeks to invoke the jurisdiction of this court to review the decision of the United States Court of Appeals for the Sixth Circuit pursuant to 28 U.S.C. § 1254(1).

STATUTES INVOLVED

The pertinent provisions of the United States Code are set forth below:

11 U.S.C. § 101(53A)

(53A) "stockbroker" means person--

(A) with respect to which there is a customer, as defined in section 741 of this title; and

(B) that is engaged in the business of effecting transactions in securities--

(i) for the account of others; or
(ii) with members of the general public, from or for such person's own account;

11 U.S.C. § 741(2)

(2) "customer" includes--

(A) entity with whom a person deals as principal or agent and that has a claim against such person on account of a security received, acquired, or held by such person in the ordinary course of such person's business as a stockbroker, from or for the securities account or accounts of such entity--

(i) for safekeeping;
(ii) with a view to sale;
(iii) to cover a consummated sale;
(iv) pursuant to a purchase;
(v) as collateral under a security agreement; or

(vi) for the purpose of effecting registration of transfer; and

(B) entity that has a claim against a person arising out of--

(i) a sale or conversion of a security received, acquired, or held as specified in subparagraph (A) of this paragraph; or

(ii) a deposit of cash, a security, or other property with such person for the purpose of purchasing or selling a security;

STATEMENT OF THE CASE

This petition is before this Court as a result of a Motion filed by the Bankruptcy Trustee (hereinafter "Trustee") seeking instructions from the Bankruptcy Court regarding liquidation. (R. 1, Motion for Instructions, July 1, 1994.) The Trustee requested direction from the Bankruptcy Court as to whether the assets of the consolidated debtors' estates should be liquidated under 11 U.S.C. § 726, or in the alternative, under the specialized stockbroker liquidation provisions pursuant to 11 U.S.C. §§ 741-752. The United States Bankruptcy Court had jurisdiction over the issue pursuant to 28 U.S.C. § 151 and 28 U.S.C. § 157(b)(1).

The underlying bankruptcy action was initially commenced as a result of an involuntary petition filed on January 17, 1987, naming three corporate debtors, Baker & Getty Financial Services, Inc. (hereinafter "BGFS"); Baker & Getty Diversified, Inc. (hereinafter "BGD"); and Baker & Getty Securities, Inc. (hereinafter "BGS"). Collectively, BGFS, BGD, and BGS will be referred to as "B&G". BGFS was formed in August 1985 for the stated purpose of becoming a fully licensed broker-dealer, however it never became licensed. BGD was subsequently formed to locate and develop real estate and to loan funds to BGFS, however like BGFS, BGD never became fully operative. BGS thereafter was formed in June 1986 to replace both BGFS and BGD and for the purpose of becoming a licensed broker-dealer. BGS, like its predecessors, BGFS and BGD never became licensed and never progressed to a point where it began generating a legitimate source of income. Instead, B&G, through its principal officer, Philip Cordek (hereinafter "Cordek"), operated a "Ponzi scheme" for the purpose of

defrauding WesBanco and all other creditors in this action.[1]

The procedural history of this action was summarized by the Sixth Circuit Court of Appeals as follows:

> On January 22, 1987, three defrauded individuals filed involuntary bankruptcy petitions against BGS, BGD and BGFS. The petitions were not contested and the bankruptcy court entered an order of relief against the three corporations on February 17, 1987. On April 28, 1987, Cordek and his wife were joined as affiliates. Then, on May 26, 1987, the bankruptcy court entered an order substantively consolidating the estates of B&G with those of Philip and Susan Cordek. Matter of Baker & Getty Fin. Servs., Inc., 78 B.R. 139 (Bankr. N.D. Ohio 1987). The bankruptcy court substantively consolidated the estates of the debtors because of unrestricted and extensively co-mingling of Philip Cordek's personal assets with B&G's corporate assets. WesBanco, which had been a creditor of Philip Cordek, individually, but not of B&G, then became a creditor of B&G.

(App. C, A11-12.)

Following the consolidation of the bankruptcy estates of Cordek and Baker & Getty, WesBanco filed a Proof of Claim on January 4, 1988 for $659,197.53. On February 18,

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[1] See *In re Indep. Clearing House Co.*, 41 B.R. 985, 995 (Bankr. D. Utah 1984), aff'd in part, rev'd in part, 62 B.R. 118 (D. Utah 1986) for a detailed description of a "Ponzi" scheme and its history.

1988, the Trustee filed an objection to WesBanco's claim. The Trustee first sought to have WesBanco's claim disallowed in its entirety. In the alternative, the Trustee requested that the claim be subordinated to those of the customer creditors, who are the respondents in this case. On June 23, 1988, the Bankruptcy Court entered a final order that allowed WesBanco's claim, however the claim was subordinated to those of the other creditors. On appeal, the United States District Court for the Northern District of Ohio reversed the Bankruptcy Court concluding that the Trustee failed to offer grounds justifying equitable subordination of WesBanco's claim. The United States Sixth Circuit Court of Appeals subsequently affirmed the District Court's determination and as a consequence, WesBanco's claim assumed an equivalent position with the claims of other general creditors. *First National Bank of Barnesville v. Rafoth* (*In re Baker & Getty*), 974 F.2d 712 (6th Cir. 1992).

On July 1, 1994, nearly two years after the decision by the Sixth Circuit allowing WesBanco's claim to be treated equally with other creditors, the Trustee filed the Motion which has resulted in the present appeal. (R. 1, Trustee Motion, 7/1/94.) Specifically, the Trustee requested direction from the Bankruptcy Court as to whether the assets of the consolidated debtors' estate should be liquidated under the general liquidation provisions of 11 U.S.C. § 726, or under the specialized provisions found in 11 U.S.C. §§ 741-752 which are limited solely to the liquidation of a stockbroker.

The Trustee never made a recommendation as to which type of liquidation the Trustee felt was more appropriate. Under an 11 U.S.C. § 726 distribution, WesBanco, like all other unsecured creditors, was anticipated to receive approximately 60% to 70% of its total claim upon

final distribution. However, if the estate was liquidated under 11 U.S.C. §§ 741- 752, nearly all other creditors would receive a full and complete return on their claim, while WesBanco, the single largest creditor, and several other general creditors would receive nothing.

On September 28, 1994, the Bankruptcy Court held an evidentiary hearing at which time the Trustee and an individual named David Perham testified. Perham had never testified in any of the numerous bankruptcy proceedings which had taken place over the previous eight years. Even though the Trustee acknowledged that no securities were ever purchased with funds provided to either B&G or Cordek, the Bankruptcy Court nevertheless ordered a stockbroker liquidation under the specialized provisions of 11 U.S.C. §§ 741-752. (App. F, A36.)

WesBanco timely appealed the Bankruptcy Court Order to the United States District Court, Northern District of Ohio. The District Court had jurisdiction of the appeal pursuant to 28 U.S.C. § 158(a). The District Court scheduled oral argument on April 28, 1995, and during oral argument, counsel for the respondents acknowledged that the debtors were not engaged in effecting any securities transactions when he stated:

> They gave money, they entrusted money to the debtor for the purpose of effecting transactions in securities. Now, it is true they did not — Baker & Getty did not purchase securities. If Baker & Getty would have purchased securities we wouldn't be here, there wouldn't be a liquidation, there wouldn't be a bankruptcy case. But the fact is they did not carry out those transactions, those individual

transactions.

(R. 20, 4/28/95; Tr. 20.)

Despite the open admission by counsel for the respondents that B&G never purchased securities, the District Court issued an Order and Memorandum Opinion affirming the Bankruptcy Court. (App. E, A27.)

WesBanco timely filed a Motion for Rehearing. On December 5, 1995, the District Court denied WesBanco's Motion for Rehearing. The District Court vacated its earlier Order of July 31, 1995, however it adopted its previously issued Memorandum Opinion. (App. D, 425.)

WesBanco thereafter timely filed its Notice of Appeal to the United States Court of Appeals for the Sixth Circuit. (R. 27, Notice of Appeal, January 4, 1996.) The Sixth Circuit had jurisdiction of the appeal pursuant to 28 U.S.C. § 158(c) and (d). The Sixth Circuit thereafter affirmed the District Court Order requiring a liquidation of the bankruptcy estate under the specialized stockbroker liquidation provisions of 11 U.S.C. § 752. (App. C, A6.) WesBanco timely filed a Petition for Rehearing with the Sixth Circuit on February 26, 1997. The United States Court of Appeals for the Sixth Circuit denied the Petition on March 7, 1997. (App. A, A1.)

STATEMENT OF FACTS

A. FACTS RELATING TO THE RESPONDENTS, CORDEK, AND BAKER & GETTY

In August, 1985, Philip Cordek and Steven Medved

formed BGFS. BGFS was to become a stockbrokerage and financial services firm. In December, 1985, Medved formed BGD for the purpose of obtaining funds from various institutions in order to loan the funds to BGFS. BGD was also to develop real investment opportunities. (App. C, A8.)

In May 1986, BGS was formed to replace BGFS and BGD for the stated purpose of becoming a licensed broker/dealer. BGS, like BGFS and BGD however never obtained proper licensing as a securities firm. (R. 1, Tr. 9/28/94, 42.) An office was opened in Youngstown, Ohio during the time that the applications were pending. However, none of the B&G companies ever progressed to the point where they conducted any business or had a legitimate source of income. (R. 1, Schwenker Dep. 45-46.); (R. 1, Cordek Dep. 44.)

Apparently frustrated by the inability to obtain proper licensing for B&G, and the inability of B&G to generate any legitimate income, Cordek made a conscious decision in 1986 to utilize B&G as a criminal enterprise. Unbeknownst to other individuals who were also working out of the B&G offices, Cordek began to orchestrate a "Ponzi scheme".

To generate funds for his scheme, Cordek told investors that his uncle who resided in New York had access to large blocks of common stock which was available for sale at a discount. Cordek told investors that he could purchase the stock at a discounted price and then quickly sell it, thereby allowing the investors to make a substantial return on their investment. Relying on Cordek's representations, the respondents paid funds either directly to Cordek or to B&G in order to take advantage of the alleged investment opportunity. Cordek, who was the sole signatory on all B&G accounts, thereby gained access to the funds. Instead of

purchasing the stock as promised, Cordek pocketed the money and paid partial returns to some of the original investors by taking funds which were contributed by the later investors. The result was a classic Ponzi scheme whereby investors are promised excessive returns on investments and where typically, the initial investors are paid the exorbitant returns in order to attract additional investors. (App. C, A9-10.)

The Bankruptcy Court in an earlier adversarial proceeding summarized the transactions involving Cordek, B&G, and the respondents as follows:

> In reliance on these representations, many individuals sought to take advantage of these alleged investment opportunities by paying various sums to Cordek. No stock was ever actually available or purchased, and investor funds were converted by Cordek for his own personal enrichment, either directly or through initial deposit in Baker & Getty accounts.

Rafoth v. Nat'l Union Fire Ins. of Pittsburgh, (*In re Baker & Getty*), 93 B.R. 559, 561 (Bankr. N.D. Ohio 1988).

The Sixth Circuit Court of Appeals in an earlier decision involving the WesBanco claim also summarized the deposits made by the respondents to B&G and Cordek as follows:

> In November 1986, it was revealed that Cordek had never purchased securities as ordered by customers and that B&G was engaged in the "Ponzi game", an investment scheme where investors are promised

> excessive returns on investments...By November, 1986, various investors dealing with B&G had been defrauded of approximately $2.5 to $3 million.

First National Bank of Barnesville v. Rafoth (*In re Baker & Getty*),
974 F.2d 712, 713 (6th Cir. 1992).

Cordek himself described the use of the funds which were provided to him and B&G by the respondents:

> Q. Do you know if peopie invested money thinking that they could buy stock at a price below its market value?
> A. Yes.
> Q. And do you know if any stock was actually bought below its market value?
> A. I don't believe so.
> Q. Ever?
> A. Ever.
>
> * * *
>
> Q. But it is your testimony that no stock was ever bought?
> A. Yes.
> Q. Yes, no stock was ever bought?
> A. Yes, no stock was ever bought.

(R. 1, Cordek Dep., 47-49.)

At the hearing held on September 28, 1994 before the

Bankruptcy Court, the Trustee also testified regarding the funds paid by the respondents to Cordek and B&G:

> Q. You indicated, Mr. Rafoth, that the checks that are noted in Exhibit 6 were deposited into Baker & Getty accounts. You have also had a chance to review those accounts. There is no indication from those accounts that a security was purchased from an account held by Baker & Getty. Would that be accurate?
>
> A. That is correct.
>
> * * *
>
> Q. And that would have been from your analysis, those funds were used to do such things as purchase a home in Shaker Heights?
>
> A. A boat, an airplane, and I believe some automobiles, that we were able to bring into the estate and liquidate and recover for the benefit of creditors.
>
> Q. A lot of things, but not for the purpose of effecting transactions in securities?
>
> A. That is an accurate--an accurate statement.

(R. 1, 9/28/94, Tr. 48.)

The Trustee also provided some insight as to how the creditors of Cordek and B&G were defrauded. When presented with Hearing Exhibit 6, which was a serious of checks and confirmation slips involving the respondents in this case, the Trustee openly admitted that the confirmation slips were fraudulent.

Q. The confirmation slips are fraudulent. Would that be an accurate statement?

A. I believe that is accurate, yes.

Q. And none of the checks which represent the payment made to Baker & Getty resulted in Baker & Getty purchasing securities for any of the individuals?

A. Not these securities that are liste on the confirmation slips.

Q. Okay.

A. If there were any others purchased, I'm not aware of any. I don't believe there were.

Q. Are any of the customer creditors that you have identified in your filing with the court, have you been able to undertake or determine whether any of those individuals had a security purchased from money that they invested with either Mr. Cordek or with the Baker & Getty entities?

A. ...because of my general understanding that the claimants might arguably, the reason we are here today, determined to be customer claimants were defrauded of their funds as a result of securities not being purchased.

(R. 1, 9/28/94, Tr. 45-47.)

No securities were ever purchased by Cordek or B&G with funds which were provided by the respondents. Instead, Cordek used the funds to further his criminal Ponzi enterprise. As a result of his activities, Cordek was convicted of criminal charges and sentenced to prison.

B. FACTS RELATING TO FUNDS PROVIDED TO MUTUAL SERVICES, INC. BY INDIVIDUALS WHO ARE NOT CREDITORS OF THIS ESTATE.

During the same period of time that Cordek was orchestrating his Ponzi scheme and defrauding the respondents of their funds, several other individuals were working out of the B&G offices as registered representatives for another brokerage firm. These individuals included Daniel Schwenker and David Perham. Neither Perham nor Schwenker were involved in the Ponzi scheme and were unaware of the criminal acts being undertaken by Cordek and B&G until early November, 1986. (R. 1, Tr. 40.)

Perham and Schwenker both knew they could not conduct any transactions through B&G, since B&G had not been able to obtain any appropriate licensing through the Securities and Exchange Commission. As a result, Perham and Schwenker acted as registered representatives for Mutual Services, Inc. (hereinafter "Mutual Services"). Mutual Services was a legitimate brokerage firm which was unrelated to B&G or Cordek. (Schwenker Dep. 45; R. 1, Tr. 24-25.)

The customers of Mutual Services who dealt with Perham and Schwenker have never been creditors of this estate, nor do they have any relationship to Cordek or B&G. Likewise, the investments which these customers purchased through Mutual Services have never been considered assets of this bankruptcy estate. Schwenker described the reason that these individuals purchased their investments through Mutual Services as opposed to B&G as follows:

> Q. Did any of them in these early months keep funds with Baker & Getty and

you would pay on the confirms?

A. Oh, no.

* * *

Q. Did Baker & Getty ever become a licensed broker-dealer?

A. No.

Q. So there was never a point in time when you were allowed to keep client funds?

A. No. Absolutely not.

Q. And the remittances were paid directly to Mutual Services?

A. Yes. Oh, yes. All my clients--any transactions that take place, if there is not money in the account, the client makes out a check directly to the broker-dealer and not out to Baker & Getty.

Q. Did your clients maintain an account balance with Mutual Services?

A. Uh huh. Some of them would.

(R. 1, Schwenker Dep. 45-46.)

The Mutual Services' customers paid their funds directly to Mutual Services. These customers never dealt with Cordek and their funds were never under the control of B&G or Cordek. (Schwenker Dep. 45; R. 1, Tr. 38.) The Mutual Services' customers maintained accounts with Mutual Services, and received the securities for which they paid. Upon payment of the appropriate amount from the investor to Mutual Services, Mutual Services completed the transaction by purchasing securities. It would then issue monthly

statements directly to its customers. Confirmation slips for the purchases were also issued directly by Mutual Services to the individuals and a copy of the confirmation slip would go to Perham or Schwenker. Furthermore, Perham and Schwenker were paid commissions directly from Mutual Services. (Schwenker Dep. 44-46.)

WesBanco has maintained that the Mutual Services activities have no relevance to the issue regarding what type of liquidation is appropriate for Cordek and B&G. However, the lower courts have based their decisions on these very transactions even though the customers of Mutual Services had no relationship with Cordek and B&G, and the respondents likewise had no relationship with Mutual Services.

This case involves two separate and distinct entities who dealt with differing individuals. The respondents, who are the creditors of this case, provided their funds directly to Cordek or B&G. Cordek in turn used these funds to further his Ponzi scheme, and admittedly none of the funds were used for the purchase of securities.

The second group involves the individuals who dealt with Mutual Services and who have never been creditors of this estate. These individuals provided funds directly to Mutual Services and Mutual Services in turn purchased securities on their behalf. The securities which were purchased have never been considered assets of this bankruptcy estate. Nevertheless, the lower courts have attributed the activities of Mutual Services as being the acts of B&G or Cordek As a result, a criminal Ponzi scheme has been judicially declared a stockbroker even though the debtors admittedly were never engaged in a securities transaction.

ARGUMENT

I. THE CASE PRESENTS AN IMPORTANT QUESTION OF LAW, TO WIT -- CAN A COURT ORDER A STOCKBROKER LIQUIDATION OF A BANKRUPTCY ESTATE WHERE THE DEBTORS ADMITTEDLY WERE INVOLVED IN A CRIMINAL PONZI SCHEME, AND WHERE THE DEBTORS' CONDUCT FAILS TO SATISFY THE STATUTORY DEFINITION OF A STOCKBROKER AS SET FORTH IN 11 U.S.C. § 101(53A).

This case presents an issue which is appropriate for a writ of certiorari. The United States Sixth Circuit Court of Appeals has rendered a decision which has significantly departed from the accepted and usual course of judicial proceedings such as to require this Court's exercise of its supervisory power. The Sixth Circuit has ordered a stockbroker liquidation of a bankruptcy estate where the debtors were admittedly involved in a criminal "Ponzi scheme". Through its decision, the Sixth Circuit has legitimized the criminal activities of the debtors for the purpose of benefitting one class of creditors over another. Condoning such criminal activity is clearly a function which the judiciary should avoid.

In order for an entity to be considered a stockbroker under bankruptcy law, a debtor must satisfy a two-part test set forth in 11 U.S.C. § 101(53A). First, the debtor must have customers as that term is defined in 11 U.S.C. § 741. Secondly, the debtor must be engaged in the business of effecting transactions in securities for the account of others.

A debtor must satisfy both parts of the test to comply with the statutory definition. *In re Berry*, 22 B.R. 950 (Bankr. N.D. Ohio, 1982.)

A customer is statutorily defined as an entity that has a claim against a person arising out of a deposit of cash, a security, or other property with such person for the purpose of purchasing or selling a security. See, 11 U.S.C. § 741(2)(B)(ii). A claim is statutorily defined as a right to payment from the debtor. 11 U.S.C. § 101(5). Therefore, a person or entity must have a claim or "right of payment" against a debtor, and the debtor furthermore must be engaged in effecting transactions in securities.

The only individuals who arguably satisfy the customer definition in this bankruptcy estate are the respondents in this action. Admittedly, they provided cash to Cordek or B&G. They are the only individuals who would have a claim or right to payment in this estate under a stockbroker liquidation.

11 U.S.C. § 101(53A) provides that in considering whether an entity is a stockbroker, the Court must apply the definition "with respect to which there is a customer". With respect to those customers, the Court must then determine whether the debtors were engaged in the business of effecting transactions in securities.

With respect to the respondents, the law requires that the debtor must have engaged in the business of effecting transactions in securities. The undisputed testimony of the two individuals who are most knowledgeable about the Ponzi scheme orchestrated by B&G and Cordek clearly demonstrate that the debtors do not satisfy the second part of the two-part test.

Cordek in his deposition testimony unequivocally

acknowledged that no stock was ever purchased from the funds which were provided by the respondents in this case. (R. 1, Cordek Dep. 47-49.) The Trustee also openly admitted that no securities were ever purchased by B&G or Cordek with the funds which were provided by the respondents. Even legal counsel for the respondents acknowledged that B&G did not purchase securities with the funds that were entrusted to them by the respondents. Based partly upon that acknowledgment, the United States District Court reluctantly acknowledged that:

> In 1985 and 1986, B&G attempted to become a broker/dealer and substitute itself in the role that Mutual filled. However, it never obtained a license nor did it make a single securities transaction as a broker/dealer. Instead, it operated a "Ponzi scheme".

(App. E, A29.)

The Sixth Circuit and the lower courts have nevertheless created a stockbroker out of a criminal enterprise by disregarding the applicable statute and existing case law dealing with Ponzi schemes. In *Wider v. Wooton*, 907 F.2d 570 (5th Cir. 1990), the Fifth Circuit Court of Appeals held that transfers made in furtherance of a Ponzi scheme cannot be considered as engaging in the ordinary course of business. The Court categorically rejected a stockbroker defense which had been presented, and indicated that if it had treated the Ponzi scheme as a legitimate activity, it would have implicitly authorized a fraudulent business practice by lending judicial support to a Ponzi scheme. The Fifth Circuit acknowledged that if it had condoned the Ponzi scheme, it would have

rewarded earlier investors at the expense of later victims.

The Ninth Circuit Court of Appeals in *Graulty v. Brooks* (*In re Bishop, Baldwin, Rewald, Dillingham and Wong, Inc.*), 819 F.2d 214 (9th Cir. 1987) has taken a similar approach. In an action to set aside a preferential transfer, the Ninth Circuit rejected a creditor's argument that the creditor received a payment within the ordinary course of business for financial affairs of the debtor. The Ninth Circuit explained its rationale:

> ...We agree with *Independent Clearing House* that Congress did not intend to protect one investor to the detriment of other investors victimized in a Ponzi scheme....
>
> We agree with bankruptcy courts that have addressed the issue that Ponzi schemes simply are not legitimate business enterprises which Congress intended to protect with Section 547(c)(2).

Graulty, 819 F.2d at 217.

The Ninth Circuit in *Graulty* also cited with approval the following excerpt from *In re Western World Funding, Inc.*, 54 B.R. 470 (Bankr. D.Nev. 1985):

> To apply [§ 547(c)(2)] to immunize these activities would lend judicial support to "Ponzi" schemes by rewarding early investors at the expense of later victims.
>
> * * *
>
> Equity requires that these creditors all share equally in whatever assets are available. If

> decisions such as this and Clearing House help to discourage these Ponzi arrangements by encouraging more careful investment activities on the part of the ordinary "consumer investor", there will be fewer defrauded creditors to sit at the defendant's table and fewer preference suits in the future.

Graulty, 819 F.2d at 217.

The same Bankruptcy Court, in an earlier decision in this case, cited the above excerpt verbatim. See, *In re Baker & Getty Financial Services, Inc.*, 88 B.R. 792 (Bankr. N.D. Ohio 1988.) However, this same Court which was previously extolling the virtue of treating creditors equally where a Ponzi scheme is involved, completely abandoned its earlier rationale by lending judicial support to the Ponzi scheme for the purpose of benefitting one set of creditors over another. The resulting impact is that the respondents will receive a full recovery on their claims while WesBanco and other similarly situated creditors will receive no distribution. Clearly, the more appropriate rationale which should have been applied by the Sixth Circuit is that rationale which has been applied by the Fifth Circuit in *Wider* and the Ninth Circuit in *Graulty*; that rationale being that where a Ponzi scheme is involved, equity requires that all creditors share equally in whatever assets are available.

It is incomprehensible that Congress would likewise have intended to allow a stockbroker liquidation of an estate which included no securities. Admittedly, the debtors were never engaged in a legitimate business and never generated a legitimate source of income. However, the Sixth Circuit has now sanctioned a stockbroker liquidation even though there

are no securities to distribute.

The purpose of the stockbroker liquidation provisions are to provide some recovery to those customers of an actual brokerage firm whose funds were used to purchase securities which are commingled among the assets in the debtors' estate. A leading treatise has reasoned that the purpose of the stockbroker liquidation provisions are to insure that all customers of a brokerage firm are grouped together consistent with the manner in which the securities are held by the broker. Customers are then determined to have net equity claims against the debtor based upon the value of the securities, or cash credited to their customer accounts if the specific securities are not otherwise identifiable or held in the customer's name. See, *2 Collier Bankruptcy Manual*, ¶ 741.02[1](3rd. Ed.1994). In other words, the stockbroker liquidation provisions are intended to apply to the situation where commonly held securities of a bankrupt stockbroker are not otherwise identifiable as the specific property of a person or entity. Under 11 U.S.C. § 751, the Trustee is obligated to deliver any customer-named securities directly to that customer. It is only the intermingled securities which are not held in the customer's name which were intended to be divided up and distributed among customers under 11 U.S.C. § 752.

Clearly, Congress never intended for the stockbroker liquidation provisions to apply where the debtor never engaged in securities transactions and as a result, never held any securities. The obvious reason is that a stockbroker liquidation is intended for the liquidation of a stockbroker, and not a criminal enterprise which never purchased even a single security. The Sixth Circuit in this case has abandoned the rationale adopted by the Fifth and Ninth Circuits which

have both refused to condone or legitimize the criminal acts of a debtor engaged in a Ponzi scheme. This court should grant this writ to resolve and rectify this miscarriage of justice and to adopt a policy of treating creditors' claims on an equal basis where a Ponzi scheme is involved.

II. WHERE THE DEBTORS IN A BANKRUPTCY ESTATE ADMITTEDLY NEVER USED FUNDS PROVIDED TO IT TO PURCHASE SECURITIES, CAN A COURT THEN LOOK TO THE CONDUCT AND TRANSACTIONS OF AN UNRELATED ENTITY THAT IS NEITHER A DEBTOR NOR A CREDITOR IN THE BANKRUPTCY ESTATE FOR THE PURPOSE OF ATTRIBUTING THAT ENTITY'S CONDUCT AS BEING THE CONDUCT OF THE DEBTOR, THUS RESULTING IN A STOCKBROKER LIQUIDATION IN A BANKRUPTCY PROCEEDING IN WHICH THERE WERE NEITHER SECURITIES TRANSACTIONS NOR COMMINGLED SECURITIES FOR DISTRIBUTION.

The Sixth Circuit has created a policy which will allow a court to look to the activities of an entity that is neither a debtor nor a creditor in a bankruptcy case for the purpose of attributing the conduct and the transactions of that entity as being the conduct of the debtor. The underlying decision demonstrates the potential danger and abuse which can arise where a court is allowed to consider the acts of third

parties who are not involved in the bankruptcy estate for the purpose of dictating the rights of those parties who are.

During the same period of time that Cordek and B&G were defrauding the respondents of their money which was paid directly to Cordek or B&G, several other individuals were operating out of the same office on behalf of Mutual Services. These customers who dealt with Perham or Schwenker purchased securities through Mutual Services and are not creditors of this bankruptcy estate. Likewise, the securities which were purchased by the customers of Mutual Services have never been considered assets of the bankruptcy estate. Nevertheless, the Sixth Circuit has ordered a stockbroker liquidation by attributing the transactions involving these individuals as somehow being conduct on the part of B&G.

Perham and Schwenker both acknowledged that they were acting as licensed representatives for Mutual Services in handling the transactions in question. Perham indicated the purpose for using Mutual Services as follows:

> Q. You also indicated that the purpose for Mutual Service Corporation was to, in fact, effect the transactions in securities?
>
> A. Yes.
>
> * * *
>
> Q. Can you--you effected transactions as a licensed representative through Mutual Services?
>
> A. Correct.

(R. 1, 9/28/94, Tr. 39-40.)

Perham likewise acknowledged that Mutual Services was the broker/dealer:

> Q. And what did you do through Mutual Services?
>
> A. Through Mutual Services, I enacted stock transactions for various clients...
>
> Q. Let me have the judge hand you exhibit 2 indicating you identify what this is?
>
> A. This is a statement, the clearing house is Mezzrow and Company, the broker/dealer is Mutual Services...

(R. 1, 9/28/94, Tr. 25.)

Schwenker's conduct was similar. Knowing that B&G could not legally accept any funds from the Mutual Services' investors, Schwenker had the investors pay their money directly to Mutual Services. Mutual Services in turn sent confirmation slips directly to the customer and paid commissions directly to their own registered representative. (R. 1, Schwenker Dep., 45-46.)

The Mutual Services' investors are clearly not the customers of B&G. 11 U.S.C. § 741(2)(B)(ii) defines a customer as an entity that has a claim against a person arising out of a deposit of cash, a security, or other property with that person for the purpose of purchasing or selling a security. The Mutual Services' investors have no claim against B&G, nor did they deposit cash, security, or any type of property with B&G. These individuals are customers of Mutual Services and no one else. Even though the Mutual Services' customers have never been creditors of B&G and even though the securities purchased through Mutual Services by these individuals have never been considered assets of the

bankruptcy estate, the lower courts have nevertheless held that the transactions are somehow attributable to the debtors in this case.

The lower courts have completely blurred the distinction between Mutual Services and the debtors. The only securities transactions which are even remotely involved in this case were those affected by registered representatives of Mutual Services for Mutual Services' customers. The funds were paid to Mutual Services, securities were purchased through Mutual Services and the customers were customers of Mutual Services. Neither the funds nor the transactions in any way involve B&G or Cordek. A court cannot lawfully use those separate transactions and somehow blend them with the facts involving B&G in order to effect a stockbroker liquidation in a case in which no securities transactions were ever effected, no securities were ever purchased, and as a result, no assets are available for such a specialized distribution.

A brief excerpt from the District Court's Memorandum Opinion details the far reaching analysis which that court had to adopt in order to reach the conclusion that B&G is a stockbroker:

> As a licensed representative of Mutual. Perham effected transactions in securities...Those transactions benefitted B&G because Perham was developing clients that B&G intended to serve in the future as it was going to replace Mutual as the broker/dealer. Thus, the Bankruptcy Court did not error when it attributed the actions of Perham--effecting transactions in securities--to B&G.

(App. E, A34.)

The District Court acknowledged that Perham was acting as a licensed representative of Mutual Services in handling the transactions involving the Mutual Services' customers. It then attributes this conduct of Mutual Services to B&G under the guise of B&G possibly reaping some future benefit. The above excerpt demonstrates the inherent danger of allowing the conduct of a party that is neither a creditor nor a debtor to somehow ultimately dictate the legal relationship of the entities who are parties to the bankruptcy estate.

The Ninth Circuit in *In re Brentwood Securities, Inc.*, 925 F.2d 325 (9th Cir. 1991) has provided an analysis which is clearly superior and more equitable than the far-reaching and erroneous analysis in the present case. The debtor in *Brentwood*, BSI, was a securities broker/dealer and was registered with the Securities and Exchange Commission. The president of BSI approached investors and informed them of a company called Comstock Mining that was in the process of a public offering. Several investors, on the recommendation of the president, made checks payable directly to Comstock, and not to the bankrupt brokerage firm.

It was later determined that no shares were ever issued by Comstock. The investors argued that they "assumed" their transactions were conducted through their brokerage firm accounts with the debtor. However, the Ninth Circuit noted that the investors' accounts with the debtor did not reflect the transactions and that nothing in the record established that the debtor had any role in the transaction. The Ninth Circuit concluded that the investors were therefore not customers of the brokerage firm and explained their

underlying rationale as follows:

> Every market has its dreamers and its crooks. Occasionally, they are one and the same. The SIPA protects investors when a broker holding their assets becomes insolvent. It does not comprehensively protect investors from the risk that some dealers will go bad or that some securities' issuers will behave dishonestly. Claimants who cannot show that they entrusted securities to *Brentwood* have no remedy under the SIPA.

Id. at 330.

The *Brentwood* court disregarded the conduct of Comstock Mining and refused to allow the conduct of that entity to dictate the legal relationship of the debtor and the creditors of the bankruptcy estate. The *Brentwood* court refused to blend the acts of the separate entities and instead looked to the substance of how the transactions occurred. If the same rationale is applied in the present case, then a stockbroker liquidation is clearly unwarranted.

It ignores logic to allow a series of transactions involving Mutual Services and their customers to control the legal relationship of WesBanco, B&G and the respondents, when the Mutual Services' investors and their securities have no relationship to this bankruptcy estate. The respondents were never "customers" of Mutual Services. Likewise, the customers of Mutual Services were never "customers" of B&G. If the securities which were actually purchased by the customers of Mutual Services were truly the result of any activity on the part of B&G, then these securities should have been retrieved by the Trustee and should have been marshaled

as assets of the estate.

The decisions of the Fifth Circuit in *Wider* and the Ninth Circuit in *Graulty* have both concluded that Congress did not intend to easily condone the activities of a fraudulent Ponzi scheme. Both circuits have concluded that in a Ponzi scheme, creditors should generally share equally in whatever assets are available. In this respect, the Sixth Circuit has placed itself at odds with these decisions by condoning the activities of a Ponzi scheme through an analysis of an entity who is not a party to this bankruptcy estate. The end result defies all logic. A stockbroker liquidation has been ordered where no securities transactions were ever effected, no securities were ever purchased, and, therefore, no assets available for such a specialized distribution.

CONCLUSION

For the reasons stated herein, the Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

/S/_____
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APPENDIX A

FILED
MAR 7 1997

Case No.: 96-3030: 96-3077

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

ORDER

IN RE:)
)
BAKER & GETTY FINANCIAL)
SERVICES, INC.,)
)
Debtor.)
)
_____/

WESBANCO BANK BARNESVILLE,
formerly known as First National
Bank of Barnesville

Appellant Cross-Appellee

v.

CARL D. RAFOTH, Trustee;

Appellee

CUSTOMER CREDITORS;

Appellee Cross-Appellant

MARK HOCEVAR; THERESA M. FRISSORA

Appellees

BEFORE: ENGEL, BROWN and COLE, Circuit Judges

Upon consideration of the petition for rehearing filed by the appellant/Cross-Appellee,

It is **ORDERED** that the petition for rehearing be, and it hereby is, **DENIED**.

ENTERED BY ORDER OF THE COURT

/S/

Leonard Green, Clerk

APPENDIX B

FILED
FEB 12 1997

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

Nos.: 96-3030; 96-3077

IN RE:)
)
BAKER & GETTY FINANCIAL)
SERVICES, INC.,)
)
Debtor.)
)
_____/

WESBANCO BANK BARNESVILLE,

Plaintiff - Appellant/Cross-Appellee,

v.

CARL D. RAFOTH, Trustee;

Defendant,

CUSTOMER CREDITORS;

Defendant - Appellee/Cross-Appellant,

MARK HOCEVAR and THERESA M. FRISSORA

Defendants.

BEFORE: **ENGEL, BROWN** and **COLE**, Circuit Judges.

JUDGMENT

ON APPEAL from the United States District Court for the Northern District of Ohio at Cleveland.

THIS CAUSE was heard on the record from the district court and was argued by counsel.

IN CONSIDERATION WHEREOF, it is ORDERED that the judgment of the district court instructing the trustee to distribute the assets of the bankruptcy estate according to the stockbroker liquidation provisions of 11 U.S.C. §§ 741-752 is AFFIRMED. IT IS THEREFORE ORDERED that the issues raised in the cross-appeal will not be addressed.

ENTERED BY ORDER OF THE COURT

/s/
Leonard Green, Clerk

A True Copy.

Attest:

/s/ Valery Field
Deputy Clerk

Issued as Mandate: March 17, 1997
COSTS: None
Filing Fee.....$
Printing.....$

Total.....$

APPENDIX C

RECOMMENDED FOR FULL-TEXT PUBLICATION
Pursuant to Sixth Circuit Rule 24

ELECTRONIC CITATION: 1997 FED App. 0054P
(6th Cir.) File Name: 97a0054p.06

Nos. 96-3030/3077

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

IN RE:	)	
	)	
BAKER & GETTY FINANCIAL	)	
SERVICES, INC.,	)	On Appeal from
	)	the United States
Debtor.	)	District Court for
	)	the Northern
	)	District of Ohio

WESBANCO BANK BARNESVILLE,

Plaintiff - Appellant/Cross-Appellee,

v.

CARL D. RAFOTH, Trustee;

Defendant,

CUSTOMER CREDITORS;

Defendant - Appellee/Cross-Appellant,

MARK HOCEVAR and THERESA M. FRISSORA

Defendants.

Decided and Filed February 12, 1997

BEFORE: **ENGEL, BROWN** and **COLE**, Circuit Judges.

BROWN, Circuit Judge. WesBanco Bank of Barnesville, Ohio ("WesBanco") appeals a judgment by the district court, in which the court affirmed an earlier decision of the bankruptcy court, instructing the trustee to distribute the assets of Baker & Getty Financial Services, Inc., Baker & Getty Diversified, Inc., Baker & Getty Securities, Inc., Philip Cordek and Suzan Cordek, collectively known as the "debtors," pursuant to the stockbroker liquidation provisions of the National Bankruptcy Review Act of 1987, 11 U.S.C. §§ 741-752 (1978). WesBanco contends that the district court, by so ruling, erred in determining that the debtors were "stockbrokers" under 11 U.S.C. § 101(53A). "Customer Creditors," investors who entrusted money with the debtors for the purpose of purchasing stock, respond that the district court correctly classified the debtors as stockbrokers. In addition, Customer Creditors cross-appeal a marginal entry order by the district court, in which the district court refused to strike references to the deposition testimony of Daniel

Schwenker and Philip Cordek from the record on appeal and from WesBanco's brief. For the following reasons, we **AFFIRM** the district court's order characterizing the debtors as "stockbrokers" and applying the stockbroker liquidation provisions and, therefore, we need not decide the issue raised by Customer Creditors in the cross-appeal.

I. FACTS AND BACKGROUND

In August 1985, Philip Cordek and Steven Medved formed Baker & Getty Financial Services ("BGFS"), a stock brokerage and financial services firm. Medved and Cordek assumed the primary duties of organizing the business after its incorporation. By December 1985, Medved formed Baker & Getty Diversified, Inc. ("BGD") to obtain funds from various institutions and in turn loan the funds to BGFS. BGD also developed real estate investment opportunities for the customers of the brokerage firm. In May 1986, Baker & Getty Securities, Inc. ("BGS") was formed to replace BGFS and BGD because of problems encountered regarding the licensing procedures for BGFS as a securities firm. For purposes of this opinion, we will refer, as do the parties and the courts below, to the three Baker & Getty corporations collectively as "B & G."

Throughout 1985 and 1986, B & G solicited customers to purchase securities. B & G advertised itself as a licensed broker-dealer and as a member of the Securities Investor Protection Corporation, and, in addition, B & G encouraged its stockbrokers to tell prospective customers that B & G was a full-service brokerage firm, capable of conducting transactions in-house. In truth, however, B & G was neither a licensed broker-dealer nor a member of the Securities Investor Protection Corporation. Instead, B & G employed

Mutual Services, Inc. ("Mutual Services"), a licensed broker-dealer, to conduct trades through a clearing house, Mesirow and Company Incorporated ("Mesirow"). Typically, B & G stockbrokers, who were also registered representatives of Mutual Services, placed orders with Mutual Services, and Mutual Services cleared the trades through Mesirow. After executing a trade, Mutual Services provided confirmation slips to both the investors and B & G stockbrokers, and commission checks to B & G stockbrokers, Daniel Schwenker, David Perham, and Phil Hammond, received valid securities, they received them without knowledge of B & G's actual status.

At the same time Schwenker, Perham, and Hammond were conducting legitimate stock transactions, Philip Cordek was conducting illegitimate transactions. To attract business, Cordek told investors that his uncle, who resided in New York, had access to large blocks of common stock available for sale at a discount. Cordek told investors that he would purchase stock at a discounted price and then quickly sell it, thereby allowing the investors to make a substantial return on their investment. Relying on Cordek's representations, Customer Creditors paid various sums to B & G in order to take advantage of the alleged investment opportunities. Cordek in turn gained access to the funds as the sole signatory on the B & G bank accounts.[1]

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[1] Cordek used five bank accounts for business and personal matters, three accounts in the name of "Baker & Getty Diversified" and two accounts in Cordek's name. Cordek used corporate funds to: (1) purchase automobiles; (2) repay his educational loans; (3) purchase a boat; (4) pay for a home and improvements; (5) buy furniture, jewelry, and other personalty; and (6) pay for hotel rooms for guests attending his wedding. *Matter of Baker & Getty*

Instead of purchasing the stocks as promised, however, Cordek pocketed the money and then paid returns to original investors by taking from principal sums contributed by new B & G investors. The result was a classic "Ponzi" scheme, an investment scheme in which investors are promised excessive returns on investments and where, typically, initial investors are paid the promised returns to attract additional investors.[2] In January and February 1986, Cordek purchased stock for himself through Perham and Mutual Services, Inc. With the money received from the "Ponzi" scheme. By November 1986, Customer Creditors had approximately $3 million.

Meanwhile, in August 1986, Cordek and Byron Rice, a long-time customer of WesBanco, approached the President of WesBanco, Charles Bradfield, to obtain a loan. Cordek and Rice borrowed $1.1 million to invest in the bond market.[3] WesBanco requested $200,000 in collateral to be presented at the closing; however, it only perfected its interest in collateral

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Fin. Servs., Inc., 78 B.R. 139, 141 (Bankr. N.D. Ohio 1987).

[2] *See In re Indep. Clearing House Co.*, 41 B.R. 985, 995 n.12 (Bankr. D. Utah 1984), *aff'd in part, rev'd in part*, 62 B.R. 118 (D. Utah 1986) for a detailed description of a "Ponzi" scheme and its history.

[3] The original loan amount of $1 million was increased to $1.1 million in exchange for the right of Bradfield to personally benefit in the bond transaction. Bradfield entered into a separate agreement with Rice on the closing date, whereby Rice afforded Bradfield an opportunity to participate in the bond transaction, giving Bradfield the right to receive any profit derived from the investment of the additional $100,000.

of the value of $55,000.[4] On the due date for the $1.1 million promissory note, Cordek told WesBanco that he could not make the payment because he had not sold the bonds purchased with the loan money. However, Cordek testified that, in truth, he sold the bonds for a loss and deposited the proceeds of the sale into his personal account. Later, WesBanco recovered $245,800 from B & G's accounts with the bank and $237,378 from Rice on the promissory note.[5]

On January 22, 1987, three defrauded individuals filed involuntary bankruptcy petitions against BGS, BGD, and BGFS. The petitions were not contested, and the bankruptcy court entered an order of relief against the three corporations

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[4] Cordek pledged collateral to WesBanco that consisted of a mortgage on Cordek's home, titles to multiple automobiles, and a lien on a boat. WesBanco received an invalid mortgage when it failed to conduct a title search on the Cordek's home, which would have informed WesBanco that Suzan Cordek, not Philip Cordek, held title to the home. In addition, although WesBanco properly perfected security interests in some of the remaining collateral, these interests were void due to the fact that they were preferential transfers under 11 U.S.C. § 547. WesBanco also required Byron Rice to put up collateral. Rice presented WesBanco with sight drafts on various bank accounts, approximately $25,000 in jewelry and cash, and titles to vehicles from his automobile business. In sum, the collateral provided by both amounted to a value of $55,000. *In re Baker & Getty Fin. Servs., Inc. V. Rafoth*, 974 F.2d 712, 714-15 n.3 (6th Cir. 1992).

[5] Although WesBanco recovered $245,800 from B & G, this court determined that $200,000 of the recovered sum was a preferential payment. Thus, WesBanco was entitled to only $45,800. *In re Baker & Getty Fin. Servs., Inc.*, 974 F.2d at 723.

on February 17, 1987. On April 28, 1987, Cordek and his wife were joined as affiliates. Then, on May 26, 1987, the bankruptcy court entered an order substantively consolidating the estates of B & G with those of Philip and Suzan Cordek. *Matter of Baker & Getty Fin. Servs., Inc.*, 78 B.R. 139 (Bankr. N.D. Ohio 1987).[6] The bankruptcy court substantively consolidated the estates of the debtors because of unrestricted and extensive commingling of Philip Cordek's personal assets with B & G's corporate assets. WesBanco, which had been a creditor of Philip Cordek, individually, but not of B & G, then became a creditor of B & G. Thus, WesBanco would not have been a creditor of B & G at all had it not been for Customer Creditors' efforts to substantively consolidate the estates of the Cordek with the B & G estate.

After seven years of contested proceedings, the trustee began to focus on the distribution of the recovered assets. On

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[6] In response to the order of substantive consolidation, WesBanco filed a proof of claim on January 4, 1988 for $659,197.53, the principal amount outstanding on the $1.1 million note. The trustee filed an objection to the claim, asking the bankruptcy court either to disallow the claim because Cordek was only an accommodation party to the promissory note or equitably subordinate WesBanco's claim to those of general unsecured creditors. On June 23, 1988, the bankruptcy court entered a final order that, although allowing WesBanco's claim, equitably subordinated it to those of the other creditors. On appeal, the United States District Court for the Northern District of Ohio reversed the bankruptcy order, concluding that the trustee failed to offer grounds justifying equitable subordination. This court subsequently affirmed the district court's determination. Consequently, WesBanco's claim assumed an equivalent position with the claims of other general creditors. *In re Baker & Getty Fin. Servs., Inc.*, 974 F.2d at 714-15.

July 1, 1994, the trustee filed a motion for instructions from the court as to the applicability of the stockbroker liquidation sections of the bankruptcy code, 11 U.S.C. §§ 741-752. In particular, the trustee wanted to know whether he should distribute the assets of the estate under the general subchapter, 11 U.S.C. § 726, or the subchapter for liquidation of a stockbroker, 11 U.S.C. §§ 741-752. Under an 11 U.S.C. § 726 distribution, WesBanco, as well as the other general creditors, expected to receive approximately 60% to 70% of its total claim upon final distribution. Under 11 U.S.C. §§ 741-752, however, WesBanco would receive no return on its claim, while Customer Creditors received a full return. Brief for Appellant at 6.

After holding a full evidentiary hearing, the bankruptcy court concluded that the assets of the debtors be distributed under the stockbroker liquidation provisions, 11 U.S.C. §§ 741-752:

> There is no dispute that the Debtor defrauded investors. The evidence in the record, however, shows that Debtor did effect transactions in securities. At a hearing on this matter, counsel for the Customer Creditors called David Perham to testify that he engaged in the business of effecting stock transactions. Perham is a licensed stockbroker who worked for Debtor during the relevant period. Perham testified that he accepted money from customers and conducted transactions in securities. Perham further testified that her personally knew of other brokers performing similar functions. Furthermore, the Court is aware from other hearings in the bankruptcy case of instances where Debtor informed

> investors that it had bought and later sold securities for the investors' accounts. From this evidence, the Court concludes that Debtor has effected transactions in securities.

Joint Appendix at 138-39. On appeal, the district court reviewed the applicability of the stockbroker liquidation provisions and entertained Customer Creditors' motion to strike references to the deposition testimony of Schwenker and Cordek from WesBanco's brief and from the record on appeal. On July 31, 1995, the district court issued a memorandum opinion affirming the bankruptcy court's order and entered a marginal entry order denying the motion to strike. This appeal followed.

II. STANDARD OF REVIEW

We review a bankruptcy appeal differently than a typical appeal from the district court. The bankruptcy court makes initial findings of fact and conclusions of law. The district court then reviews the bankruptcy court's findings of fact for clear error and the bankruptcy court's conclusions of law *de novo*. Bankruptcy Rule 8013. We in turn review the bankruptcy court's findings of fact for clear error and the district court's conclusions of law *de novo*. *See In re Baker & Getty Fin. Servs., Inc.*, 974 F.2d at 717. Because the district court's determination to apply the stockbroker liquidation provisions involves a mixed question of law and fact, "we must break it down into its constituent parts and apply the appropriate standard of review for each part." *In re Batie*, 995 F.2d 85, 88 (6th Cir. 1993) (citing *In re Brown*, 951 F.2d 564, 567 (3d Cir. 1991)). Therefore, we review the factual findings of the bankruptcy court for clear error, while we review *de novo* the district court's conclusions of law. *In*

re Batie, 995 F.2d at 88 (citing *In re Barrett*, 964 F.2d 588, 591 (6th Cir. 1992)); *In re Edward M. Johnson & Assocs., Inc.*, 845 F.2d 1395, 1401 (6th Cir. 1988)). We will not disturb the bankruptcy court's findings of fact unless there is the "most cogent evidence of mistake of justice." *In re Johnson*, 845 F.2d at 1401 (quoting *Slodov v. United States*, 552 F.2d 159, 162 (6th Cir. 1977), *rev'd on other grounds*, 436 U.S. 238 (1978)).

III. ANALYSIS

A.

With this standard in mind, we turn to the first issue before the court: whether the bankruptcy court appropriately determined that the debtors were stockbrokers under 11 U.S.C. § 101(53A) and, therefore, subject to the stockbroker liquidation provisions of 11 U.S.C. §§ 741-752.[7] We look to 11 U.S.C. § 101(53A) for the definition of stockbroker.[8]

---

[7] The distribution of the assets of the debtor's estate in a stockbroker liquidation differ markedly from that of a typical Chapter 7 liquidation. Under a Chapter 7 liquidation, the general unsecured creditors receive a pro rata share of the debtor's assets after a payment of priority claims. Whereas, under a stockbroker liquidation, a separate fund of "customer property" under section 741(4) is designated for the benefit of a separate class of "customer creditors," and the remainder is distributed to unsecured creditors, such as WesBanco. *In re ESM Gov't Sec., Inc.*, 812 F.2d 1374, 1375 (11th Cir. 1987).

[8] Prior to October 24, 1994, the stockbroker definition appeared in 11 U.S.C. § 101(54). Thus, all of the opinions published before October 24, 1994, refer to paragraph 54 rather than its redesignated number, 53A.

That section reads:

> (53A) "stockbroker" means person --
>
> > (A) with respect to which there is a customer, as defined in section 741(2) of this title; and
> > (B) that is engaged in the business of effecting transactions in securities --
> >
> > > (I) for the account of others; or
> > > (ii) with members of the general public, from or for such person's own account.

From this definition, two criteria exist for a debtor to be classified as a stockbroker: (1) the debtor must have customers, and (2) the debtor must be engaged in the business of effecting transactions in securities. If B & G falls short of either requirement, then the assets of the estate must be distributed in a general liquidation pursuant to 11 U.S.C. § 726. *In re Berry,* 22 B.R. 950 (Bankr. N.D. Ohio 1982).

Addressing the customer element, WesBanco contends that the debtors in the instant case did not have "customers." The parties agree that Section 741(2)(B)(ii) contains the applicable definition of customer. It defines a customer as, *inter alia*, an "entity that has a claim against a person arising out of a deposit of cash, a security, or other property with such person for the purpose of purchasing or selling a security." 11 U.S.C. § 741(2)(B)(ii). Likewise, the parties agree that Customer Creditors have a "claim" against B & G. *See* 11 U.S.C. § 101(5) (defining a "claim" as a "right to payment, whether or not such right is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured").

WesBanco argues that the language of the customer definition -- "for the purpose of purchasing or selling a security" -- requires that a *licensed* broker-dealer purchase stock for investors. According to WesBanco, B & G had no customers because it neither purchased securities for the accounts of Customer Creditors nor was it a licensed broker-dealer. However, the language of section 741(2)(B)(ii) does not include these criteria, and the legislative history suggests that a customer includes "anybody that interacts with the debtor in a capacity that concerns security transactions." *See* H.R. REP. NO. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 6223-27. We agree with the district court that the definition of customer turns on the purpose of the creditor rather than the status or intent of the debtor. An investor qualified as a customer when the investor deposits money or securities with the debtor with the expectation that the debtor purchase stock or trade securities. *Wider v. Wootton*, 907 F.2d 570, 573 (5th Cir. 1990).[9] "[I]t is the act of entrusting the cash to the debtor for the purpose of effecting securities transactions that triggers the customer status provisions."

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[9] In *Wider v. Wootton*, the debtor, Ronald Cohen operated a "Ponzi" scheme. The Fifth Circuit held that the investors were not "customers" because clients paid for the securities only after the securities were purchased and the clients had received stock certificates and confirmation slips. According to the court, "Cohen's clients did not provide Cohen a reservoir of cash from which to purchase securities." *Wider*, 907 F.2d at 573. Therefore, the logical corollary is that, had the debtors provided a reservoir of cash from which the debtor might have purchased securities, the investors would have been customers. *Id.* at 572 ("Subsection (2)(B)(ii) allows customer status when the purchaser deposits cash with the debtor so that the debtor might purchase securities.").

Matter of ESM Gov't Sec., Inc., 812 F.2d 1374 (11th Cir. 1987). Whether the debtor plans to purchase securities with the funds or defraud investors is irrelevant. In the instant case, Customer Creditors made checks payable to Baker & Getty that included descriptions of the type and amount of stock to be purchased. In addition, confirmation slips corroborate the check amounts and the anticipated stock purchases. Clearly, Customer Creditors deposited funds with B & G for the purpose of purchasing securities. We conclude, therefore, that the bankruptcy court appropriately determined that Customer Creditors were customers under 11 U.S.C. § 741(2).

Turning to the second prong of the definition, B & G must have "engaged in the business of effecting transactions in securities" in order to qualify as a "stockbroker." 11 U.S.C. § 101(53A). When determining whether B & G's activities amounted to a business of effecting securities transactions, we begin with the language of the statute. *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 756 (1975). A basic principle which must guide our interpretation of the statute is that we give the words of the statute their "plain" meaning. *Massachusetts Fin. Serv. Inc. v. Securities Investor Protection Corp.*, 545 F.2d 754, 756 (1st Cir. 1976) (quoting *Caminetti v. United States*, 242 U.S. 470 (1917), *cert. denied*, 431 U.S. 904 (1977)). The operative term, in this case, is "effecting," which Webster's defines as "something brought about by an agent or cause," or "the capacity to achieve the desired result." WEBSTER'S II NEW RIVERSIDE UNIVERSITY DICTIONARY 418 91984). "Effecting" is also defined as "to cause to happen, to bring about." A DICTIONARY OF MODERN LEGAL USAGE 306 (1995). Using these definitions of "effecting," along with a common sense application of the ordinary

meaning of the term, our task is to determine whether B & G's activities can be characterized as causing securities transactions.

WesBanco contends that the district court erred when it concluded that B & G's activities could be characterized as "effecting" securities transactions. WesBanco asserts that B & G's activities did not "effect" securities transactions because: (1) B & G was not a licensed broker-dealer and, accordingly, could not execute trades; (2) Mutual Services, not B & G, conducted trades for investors and, therefore, acted as the "stockbroker;" and (3) B & G did not purchase stock with the money deposited by Customer Creditors. We will address each of WesBanco's arguments in the order presented herein.

WesBanco first contends that the bankruptcy court erred when it attributed the securities transactions conducted by B & G stockbrokers, simultaneously acting as registered representatives of Mutual Services, to B & G. According to WesBanco, Mutual Services, a licensed broker-dealer, actually "effected" the transactions for B & G investors. WesBanco suggests that licensing creates a bright-line test for determining whether one "effects" a transaction. Section 101(5), however, does not require that one be a licensed broker-dealer before becoming a stockbroker, and nothing in the legislative history suggests that the legislature intended that licensed broker-dealers alone qualify for stockbroker status. *See* H.R. REP. NO. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 6223-27. The only courts that have addressed this issue have concluded that one can be a stockbroker, regardless of whether the person is licensed. *See In re McMillan Rapp & Co.*, 38 F. Supp. 40, 41 (E.D.Pa. 1941), *aff'd*, 123 F.2d 428 (3d Cir. 1941) (finding the debtor to be a stockbroker, notwithstanding that neither the debtor nor any

of its officers, directors, or employees was a member of any stock exchange, the debtor was listed under "investors" and not stockbrokers under the yellow pages, and its letterhead read "Investment Securities."). Furthermore, while licensing serves the function of "protect[ing] the public from the financial insecurity and fraudulent activities of persons regularly engaged in the sale of securities," the purpose of the stockbroker liquidation provisions is to provide a clear and equitable manner of distributing the assets of the debtor's estate. *See SEC v. Alan F. Hughes, Inc.*, 461 F.2d 974, 977 (2d Cir. 1972); *Colorado v. Milne*, 690 P.2d 829, 835 (Colo. 1984); *Oregon v. Crooks*, 734 P.2d 374, 376 (Or. Ct. App. 1987). Because the purposes of the statutes reveal no justification for equating licensing with effecting transactions in securities, we will not impose such a requirement.

We also conclude that WesBanco's interpretation is inconsistent with the "plain meaning" of the statute. To illustrate our point, we offer the following hypothetical. A person contacts a dealership for the purpose of purchasing a Ford truck. The salesperson represents to the purchaser that he is capable of placing an order for the truck. Unbeknownst to the purchaser, the dealership is not a licensed Ford franchisee and, therefore, is incapable of completing the transaction. Instead, the salesperson, also working for a licensed franchisee, passes the purchaser's order to the licensed franchisee that executes the purchase. In this hypothetical, applying the ordinary meaning of "effects," we would say that the unlicensed dealership effects the transaction because it is an essential link in the chain of distribution. This hypothetical is not unlike the instant case. In a typical transaction, investors entered B & G's offices and directed its stockbrokers to buy or sell securities. B & G stockbrokers, also working for Mutual Services, then placed

orders with Mutual Services, which in turn cleared the trades through Mesirow. Mutual Services then sent confirmation slips to the investors and the B & G stockbrokers. Similar to the unlicensed dealership in the hypothetical, B & G served as a conduit for purchases. Both B & G and the unlicensed dealership also facilitated transactions at a key point in the chain of distribution. We conclude, therefore, that WesBanco's argument that Mutual Services, but not B & G, "effected transactions in securities" is without merit.

WesBanco further contends that, even if the orders placed by Mutual Services can be attributed to B & G, B & G cannot properly be characterized as a stockbroker with respect to Customer Creditors because B & G did not purchase securities with the money deposited by Customer Creditors. Rather, Cordek mislead Customer Creditors into believing that their money would be spent on particular securities when, in fact, Cordek used Customer Creditors' money for his own benefit.[10] In our view, however, WesBanco's argument is contrary to the National Bankruptcy Review Act's definition of stockbroker. Section 101(5) defines a stockbroker, not on a customer-by-customer basis, but as one "engaged in the business...." In other words, we look not to a single maverick transaction when determining whether a person is a stockbroker, but instead, to the

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[10] The district court concluded that, because Cordek commingled Customer Creditors' money with his own and later purchased securities with the commingled money in his personal account, Cordek used Customer Creditors' money to purchase securities, albeit indirectly. In our view, however, the proceedings below failed to develop a sufficient factual record as to whether Customer Creditors' money can be traced to the purchased securities. Accordingly, we will not rule on this theory.

underlying business at issue. *See Massachusetts Fin. Servs., Inc. v. Securities Investor Protection Corp.*, 411 F. Supp. 411, 415 (D. Mass. 1976), *aff'd*, 545 F.2d 754 (1st Cir. 1976), *cert. denied*, 431 U.S. 904 (1977). In this case, the record reflects that, except for Cordek's dealings with Customer Creditors, B & G conducted legitimate business with *all* its customers. B & G, having achieved "stockbroker" status by virtue of its lawful business, has such status as to Customer Creditors as well. Moreover, if we were to conclude otherwise, we would provide less protection for customers who lost their money to fraud than for those who lost their money as a result of honest mismanagement. We see no justification for such a rule.[11]

The facts in the record indicate that B & G effected securities transactions, albeit with the aid of Mutual Services. In particular, B & G enticed customers to invest their money through B & G. Investors, lured in by B & G's corporate offices and advertisements representing B &B G as a licensed broker-dealer, placed money in the hands of B & G stockbrokers for the purpose of purchasing stock. B & G

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[11] Our result is driven, in part, by policy implications. The stockbroker liquidation provisions of the National Bankruptcy Review Act of 1987 evolved from provisions set forth in section 60(e) of the 1898 Bankruptcy Act and particular sections of the Security Investors Protection Act of 1970 ("SIPA"). *Matter of SSIW Corp.*, 7 B.R. 735, 738-39 (Bankr. S.D.N.Y. 1980) (citing H.R. REP. NO. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 6223-27)). The legislative purpose behind these statutes was to protect and provide equality of treatment for public customers of securities brokers. *SEC v. First Sec. Company of Chicago*, 507 F.2d 417, 420 (7th Cir. 1974) (citation omitted); *SEC v. Alan F. Hughes, Inc.*, 461 F.2d at 977.

stockbrokers told investors that B & G was a full-service brokerage firm, capable of conducting securities transactions in-house. B & G stockbrokers, who were also registered representatives of Mutual Services, placed orders for trades through Mutual Services. All the while, B & G had taken steps to substitute itself in the position of Mutual Services by applying for licensing as a broker-dealer with the Securities and Exchange Commission. Because B & G's stockbrokers were registered representatives of Mutual Services, they could use Mutual Services to execute trades, yet maintain the strong client base should B & G become a licensed broker-dealer. First, B & G was responsible for soliciting investors, without which there would have been no securities transactions. Second, B & G's stockbrokers, as registered representatives of Mutual Services, executed transactions in securities. *See In re Berry*, 22 B.R. 950, 952 (Bankr. N.D. Ohio 1982). Finally, from the beginning, B & G operated with the intention that it replace Mutual Services upon licensing. We conclude, therefore, that B & G's activities effected transactions in securities.

Accordingly, the district court properly determined that the stockbroker liquidations provisions under 11 U.S.C. §§ 741-752 governed the distribution of the assets in the bankruptcy estate.

B.

On cross-appeal, Customer Creditors contend that the district court erred by denying their motion to strike all references to the deposition testimony of Daniel Schwenker and Philip Cordek from the record on appeal and from WesBanco's brief. We do not find it necessary to make a determination as to the merits of Customer Creditors' cross-

appeal because David Perham's testimony alone provides adequate support to affirm the district court's order. In addition, even considering the testimony of Daniel Schwenker and Philip Cordek, we would reach the same conclusion.

IV. CONCLUSION

Having determined that B & G was a stockbroker pursuant to 11 U.S.C. § 101(53A), we **AFFIRM** the district court's order instructing the trustee to distribute the assets of the bankruptcy estate according to the stockbroker liquidation provisions of 11 U.S.C. §§ 741-752.

APPENDIX D

95 DEC 5

IN THE U.S. DISTRICT COURT
NORTHERN OHIO DISTRICT
CLEVELAND

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

WESBANCO BANK BARNESVILLE fka THE FIRST NATIONAL BANK OF BARNESVILLE,	)	CASE NO.: 4:95CV0089
Appellant,	)	
v.	)	Judge John M. Manos
CARL D. RAFOTH, TRUSTEE, et al.,	)	
Appellee.	)	

ORDER

On October 31, 1994, the United States Bankruptcy Court for the Northern District of Ohio entered an order that

the assets of the bankruptcy estates of Baker & Getty Financial Services, Inc. (BGFS), Baker & Getty Diversified, Inc., (BGD), Baker & Getty Securities, Inc (BGS) (collectively, B & G), Philip Cordek (Cordek) and Suzan Bierman Cordek, the debtors, shall be distributed under the bankruptcy code relating to stockbroker liquidations, 11 U.S.C. § 752.

On January 12, 1995, WesBanco Bank Barnesville fka The First National Bank of Barnesville (WesBanco), the appellant, filed an appeal. On April 28, 1995, the court heard arguments of counsel, and on July 31, 1995, it issued a memorandum of opinion and an order affirming the order of the bankruptcy court.

On August 10, 1995, WesBanco filed a motion for rehearing, and on August 31, 1995, it filed a brief in support. On September 7, 1995, the court heard arguments of counsel. On September 19, 1995, WesBanco filed a supplemental brief.

WesBanco argues that the court should reconsider its opinion and reverse the order of the bankruptcy court. However, in its briefs, it does not cite additional authority in support of its position, which was considered and rejected. Accordingly, its motion for rehearing is denied.

Further, the order of this court dated July 31, 1995 (Doc. #18), is vacated; the reasoning of the memorandum of opinion dated July 31, 1995 (Doc. #17) is adopted; and, the order of the bankruptcy court is affirmed.

IT IS SO ORDERED.

/s/
UNITED STATES DISTRICT JUDGE

APPENDIX E

FILED
95 JUL 31
CLERK U.S. DISTRICT COURT
NORTHERN OHIO DISTRICT
CLEVELAND

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF OHIO EASTERN DIVISION

WESBANCO BANK BARNESVILLE fka THE FIRST NATIONAL BANK OF BARNESVILLE,	)	CASE NO.: 4:95CV0089
Appellant,	)	
v.	)	Judge John M. Manos
CARL D. RAFOTH, TRUSTEE, et al.,	)	
Appellee.	)	

On October 31, 1994, the United States Bankruptcy Court for the Northern District of Ohio entered an order that the assets of the bankruptcy estates of Baker & Getty Financial Services, Inc. (BGFS), Baker & Getty Diversified, Inc. (BGD), Baker & Getty Securities, Inc. (BGS)

(collectively, B & G), Philip Cordek (Cordek) and Suzan Bierman Cordek, the debtors, shall be distributed under the bankruptcy code relating to stockbroker liquidations, 11 U.S.C. § 752.

The case is before this court on appeal by WesBanco Bank Barnesville fka The First National Bank of Barnesville (WesBanco), the appellant. Jurisdiction is predicated up 28 U.S.C. § 158(a). For the following reasons, the bankruptcy court is affirmed.

In August 1985, Cordek and Steven Medved formed BGFS for the purpose of operating a stock brokerage and financial services firm. In December 1985, BGD was formed to develop real estate investments. In May 1986, BGS filed an application for registration as a broker-dealer with the National Association of Securities Dealers[1] and held itself out to the public as a licensed broker-dealer. *In re Baker & Getty*, 78 B.R. 139, 140 (Bankr. N.D. Ohio 1987).

From August 1985, until November 1986, David Perham worked for B & G as a licensed broker and facilitated legitimate securities transactions.[2] Although he told investors that B & G was the broker-dealer which conducted his transactions, he used Mutual Services, Inc. (Mutual) because it was a licensed broker-dealer.[3] Transactions operated as follows: an investor would direct Perham to buy or sell certain securities; he would inform Mutual, and it would

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[1] BGS later withdrew its application, and it never became licensed as a broker-dealer.

[2] The record indicates that Daniel Schwenker, Philip Hammond and Gregg DeSilvio also worked for B & G as licensed brokers.

[3] In April 1986, American Capital Equity, Inc. Replaced Mutual as the broker-dealer used by employees of B & G.

make the transaction; Mutual would send one confirmation slip to the investor and one to Perham; thereafter, the investor would make payment directly to Mutual, and it would send a commission check to Perham. (Hr'g Tr. at 21-39.)

In 1985 and 1986, B & G attempted to become a broker-dealer and substitute itself in the role that Mutual filled. However, it never obtained a license nor did it make a single securities transaction as a broker-dealer. Instead, it operated a "Ponzi scheme."[4] Cordek told investors that he could buy stocks at discounted prices through his uncle and immediately sell them for a profit. Some investors (the individual creditors) transferred money directly to B & G so that Cordek could buy stock. However, he did not purchase any stock through his uncle. *In re Baker & Getty*, 93 B.R. 559, 561 (Bankr. N.D. Ohio 1988);[5] *In re Baker & Getty*, 974 F.2d 712, 714 (6th Cir. 1992);[6] (Hr'g Tr. at 45-47). Rather than buy the stock as he had promised, he took some of the funds deposited with B & G and paid previous investors to attract others. He also commingled the accounts of B & G with his personal accounts. *In re Baker & Getty*, 78 B.R. at 143. Further, in January and February 1986, he bought stock (in his own name) through Perham and Mutual using funds from his personal accounts. (*See* Hr'g Ex. 2.)

On August 27, 1986, WesBanco loaned 1.1 million

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[4] A Ponzi scheme is any fraudulent arrangement that uses later acquired funds to pay off previous investors.

[5] "No stock was ever actually available or purchased, and investor funds were converted by Cordek for his own personal enrichment, either directly or through initial deposit in Baker & Getty accounts."

[6] "Cordek had never purchased securities as ordered by customers."

dollars to Byron Rice and Cordek so that Rice could buy stock through B & G. Cordek then bought stock using the proceeds from the loan. *In re Baker & Getty*, 78 B.R. at 141.[7] After a few days, the stock was sold at a loss, Cordek transferred the proceeds to his personal accounts, and none of the proceeds was ever used to repay the loan. *Id.* Wesbanco did not perfect a security interest in the proceeds of its loan and is still owed $770,428.75.[8]

In November 1986, the individual creditors learned that they had been defrauded of more than 2 million dollars. On January 22, 1987, they filed a petition for involuntary bankruptcy against B & G. On April 28, 1987, Cordek and his wife were joined in the proceedings. On September 8, 1987, the bankruptcy estates of B & G and those of Cordek and his wife were consolidated. *In re Baker & Getty*, 78 B.R. at 143. WesBanco, which had been a creditor of Cordek, individually, but not of B & G, then became a creditor of the debtors.

On July 1, 1994, Carl D. Rafoth, the bankruptcy trustee, filed a motion for instructions from the bankruptcy court as to whether the distribution should proceed under 11 U.S.C. § 726, the general subchapter, or 11 U.S.C. § 752, the subchapter used for the liquidation of a stockbroker. On September 28, 1994, the bankruptcy court held a hearing to determine whether B & G was a stockbroker under the

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[7] "[I]n August 1986, CORDEK and Rice obtained a loan from the Bank in the amount of 1.1 million dollars, which was used to purchase various securities. The securities were sold within days and the proceeds transferred to CORDEK's account."

[8] In September 1987. WesBanco entered into a settlement agreement with Rice whereby he agreed to pay $225,000. WesBanco and the bankruptcy trustee have agreed that the amount of its claim is $770,428.75.

bankruptcy code. On October 31, 1994, the bankruptcy court held that B & G was a stockbroker and ordered the assets of the debtors distributed under 11 U.S.C. § 752.

II.

When reviewing the decision of a bankruptcy court, a district court functions as an appellate court and applies the standard of review applied by the federal courts of appeals. *In re Matter of Webb*, 954 F.2d 1102, 1103-04 (5th Cir. 1992). Conclusions of law are subject to *de novo* review, and findings of fact are not set aside unless clearly erroneous. *In re Baker & Getty*, 974 F.2d at 716 (citing *In re Edward M. Johnson and Assoc., Inc.*, 845 F.2d 1395 (6th Cir. 1988)). Further, "due regard shall be given to the opportunity of the bankruptcy court to judge the credibility of witnesses." Bankruptcy Rule 8013.

III.

Title 11 U.S.C. § 101(54) defines a stockbroker as a person:

> (A) with respect to which there is a *customer*, as defined in section 741(2) of this title; *and*
> (B) *that is engaged in the business of effecting transactions in securities* –
> (I) for the account of others; or
> (ii) With members of the general public, from or for such person's own account.

(emphasis added.)

Thus, there are two requirements for a debtor to be classified as a stockbroker: (1) that the debtor have a customer, and (2) that the debtor be engaged in the business of effecting transactions in securities.

A customer is defined as an "entity that has a claim against a person arising out of ... a deposit of cash, a security, or other property with such person for the purpose of purchasing or selling a security." 11 U.S.C. § 741(2)(B)(ii). WesBanco argues that whether a creditor is a customer depends on the intention of the debtor, and not the creditor. Because B & G never intended to purchase securities, it never had any customers. Therefore, WesBanco argues, the bankruptcy court erred as a matter of law when it concluded that the individual creditors were customers because *they* intended that B & G purchase securities.

The argument of WesBanco is without merit. Whether a person is a customer turns on the "purpose" of the creditor. The intent of the debtor (either to defraud or to purchase stock) is irrelevant. *See In re ESM Government Securities, Inc.*, 812 F.2d 1374, 1376 (11th Cir. 1987); [9] *accord Wider v. Wootton*, 907 F.2d 570, 573 (5th Cir. 1990);[10] *In re Brentwood Securities, Inc.*, 925 F.2d 325, 327 (9th Cir. 1991);[11] *In re Berry*, 22 B.R. 950, 952 (Bankr. N.D. Ohio

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[9] "[I]t is the act of *entrusting* the cash to the debtor for the purpose of effecting securities transactions that triggers the customer status provision." (Emphasis added.)

[10] The creditors "paid for the securities ... only after [the debtor] had obtained a certificate and sent a confirmation slip. [They] did not provide ... a reservoir of cash from which to purchase securities. Accordingly, [the debtor]'s clients are not 'customers' under terms of subsection [741](2)(B)(ii)." The logical corollary is: had the creditors given the debtor cash prior to the transaction, they would have been customers.

[11] Applying a similar statute, the court stated: "[a]n investor is [a customer] only if he has entrusted cash or securities to a broker-dealer who becomes insolvent; if an investor has not so

1982).[12] Accordingly, the bankruptcy court did not err when it held that the individual creditors were "customers" under 11 U.S.C. § 741(2)(B)(ii).

WesBanco also argues that the finding of fact by the bankruptcy court that B & G engaged in the business of effecting transactions in securities was clearly erroneous. The bankruptcy court determined:

> The remaining issue is whether Debtor engaged in the business of effecting transactions in securities. WesBanco argues that Debtor operated a Ponzi scheme and did not effect transactions in securities. There is no dispute that the Debtor defrauded investors. The evidence in the record, however, shows that Debtor did effect transactions in securities. At a hearing on this matter, counsel for the Customer Creditors called David Perham to testify that he engaged int he business of effecting stock transactions. Perham is a licensed stockbroker who worked for Debtor during the relevant period. Perham testified that he accepted money from customers and conducted transactions in securities. Perham further testified that he

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entrusted cash or securities , he is not a customer."

[12] "In order to have a customer ..., a person must act as a principal or agent for another and that other must hold a claim against his principal/agent on account of a security." The court held that an employee of the agent does not have customers because he is not the principal/agent of the customer. In the present case, B & G had customers because it acted as the principal/agent of the individual creditors.

> personally knew of other brokers performing similar functions. Furthermore, the court is aware from other hearings in the bankruptcy case of instances where Debtor informed investors that it had bought and later sold securities for the investors' accounts. From this evidence, the Court concludes that Debtor has effected transactions in securities.

In re Baker & Getty, No. B87-00074-Y, slip op. At 3-4 (Bankr. N.D. Ohio filed Oct. 31, 1994).

WesBanco asserts that the bankruptcy court erroneously determined that B & G was a broker-dealer for the legitimate transactions conducted by Perham. However, WesBanco misreads the findings of the bankruptcy court. It found: (1) B & G employed Perham; and (2) Perham "conducted transactions in securities" during the time that B & G was attempting to become a broker-dealer.

As a licensed representative of Mutual, Perham effected transactions in securities. *See In re Berry*, 22 B.R. at 952.[13] Those transactions benefited B & G because Perham was developing clients that B & G intended to serve in the future as it was going to replace Mutual as the broker-dealer. Thus, the bankruptcy court did not err when it attributed the actions of Perham -- effecting transactions in securities -- to B & G.

In addition, there is evidence that Cordek commingled his personal funds with those of B & G and that he bought stock through Perham (and Mutual). The individual creditors deposited their money with B & G, Cordek commingled the

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[13] While an account executive is not a stockbroker because he does not have customers, he is engaged in the business of effecting transactions in securities.

funds of B & G with his personal accounts, and he purchased stock. (*See* Hr'g Ex. 2.) Further, Cordek bought stock using proceeds from the 1.1 million dollar loan. *See In re Baker & Getty*, 78 B.R. at 141. Therefore, the bankruptcy court had sufficient evidence to determine that B & G "engaged in the business of effecting transactions in securities." 11 U.S.C. § 101(54)(B).

WesBanco further argues that the bankruptcy court erred as a matter of law when it applied 11 U.S.C. § 752 to an entity that operated a scam because to do so would "lend[] judicial support to Ponzi schemes." (Appellant's Br. At 27.) However, the language of the bankruptcy code requires that the stockbroker liquidation provision apply to all debtors who are stockbrokers as defined by 11 U.S.C. § 101(54). It does not provide an exception for debtors who defraud their customers. Thus, the bankruptcy court properly applied 11 U.S.C. § 752.

Accordingly, the order of the bankruptcy court is affirmed.

IT IS SO ORDERED.

/s/
UNITED STATES
DISTRICT JUDGE

FILED
95 JUL 31
CLERK U.S. DISTRICT COURT
NORTHERN OHIO DISTRICT
CLEVELAND

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

WESBANCO BANK BARNESVILLE fka THE FIRST NATIONAL BANK OF BARNESVILLE,	)	CASE NO.: 4:95CV0089
Appellant,	)	
v.	)	Judge John M. Manos
CARL D. RAFOTH, TRUSTEE, et al.,	)	
Appellees.	)	

ORDER

Pursuant to the Memorandum of Opinion issued in the above captioned case this date, the order of the bankruptcy court is affirmed.

IT IS SO ORDERED.

UNITED STATES DISTRICT JUDGE

APPENDIX F

FILED
OCT 31 1994

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO

IN RE:	)	
	)	
BAKER & GETTY FINANCIAL SERVICES, INC.,	)	CASE NUMBER B87-00074-Y
	)	
Debtor.	)	
	)	

ORDER

This cause is before the Court on the motion of the Chapter 7 Trustee asking the Court for instructions on whether to distribute the assets of Debtor's estate under 11 U.S.C. § 726 or 11 U.S.C. § 752. The Trusteed believes that it would be reasonable to distribute the assets under either section, but because of the large dollar amounts involved seeks the Court's advice on which section is appropriate. Several interested creditors have filed documents stating their respective positions on whether the Trustee should distribute the assets of the estate under the stockbroker liquidation provisions. The lone creditor speaking against the use of the

stockbroker liquidation provisions is WesBanco Bank Barnesville, f.k.a. The First National Bank of Barnesville. There are several creditors who invested funds with Debtor who argue that the stockbroker liquidation provisions should apply. The court will refer to this group of creditors as the Customer Creditors.

The stockbroker liquidation provisions of Chapter 7 are found in §§ 741-752. These provisions contain no triggering mechanism. They apply whenever the debtor is a stockbroker. There are no other requirements. This matter, therefore, hinges on whether Debtor fits the definition of a stockbroker found in 11 U.S.C. § 101(54). The Bankruptcy Code defines a stockbroker as a person

> (A) with respect to which there is a customer, as defined in section 741(2) of this title; and
> (B) that is engaged in the business of effecting transactions in securities --
> (I) for the account of others; or
> (ii) with members of the public, form or for such person's own account;

11 U.S.C. § 101(54). Thus, there are two requirements for a debtor to be classified as a stockbroker for purposes of the stockbroker liquidation sections: (1) that there be a customer and (2) that the debtor engage in the business of effecting transactions in securities.

The Bankruptcy Code states that the definition of a customer includes

> (A) [an] entity with whom a person deals as principal or agent and that has a claim against such person on account of a security received,

acquired, or held by such person in the ordinary course of such person's business as a stockbroker, from or for the securities account or accounts of such entity --

(I) for safekeeping;

(ii) with a view to sale;

(iii) to cover a consummated sale;

(iv) pursuant to a purchase;

(v) as collateral under a security agreement; or

(vi) for the purpose of effecting registration of transfer; and

(B) [an] entity that has a claim against a person arising out of --

(I) a sale or conversion of a security received, acquired, or held as specified in subparagraph (A) of this paragraph; or

(ii) a deposit of cash, a security, or other property with such person for the purpose of purchasing or selling a security;

11 U.S.C. § 741(2).

The relevant subparagraph in the present matter is 11 U.S.C. § 741(2)(B)(ii). WesBanco argues that none of the Customer Creditors are statutory customers because none of the Customer Creditors made any deposit with a stockbroker who intended to purchase securities. The Customer Creditors assert that they are statutory customers because they deposited funds with Debtor for the purpose of acquiring securities. WesBanco's argument relies on the proposition that the Court must examine the intent of the person with whom the funds were deposited to determine if the depositor is a customer.

This proposition is without merit as the plain language of the statute shows that the Court must examine the intent of the depositor. Here, the evidence shows the Customer Creditors made the deposits for the purpose of effecting transactions in securities. The Customer Creditors fit the statutory definition of 11 U.S.C. § 741(2)(b)(ii).

The remaining issue is whether Debtor engaged in the business of effecting transactions in securities. WesBanco argues that Debtor operated a Ponzi scheme and did not effect transactions in securities. There is no dispute that the Debtor defrauded investors. The evidence in the record, however, shows that Debtor did effect transactions in securities. At a hearing on this matter, counsel for the Customer Creditors called David Perham to testify that he engaged in the business of effecting stock transactions. Perham is a licensed stockbroker who worked for Debtor during the relevant period. Perham testified that he accepted money from customers and conducted transactions in securities. Perham further testified that her personally knew of other brokers performing similar functions. Furthermore, the Court is aware from other hearings in the bankruptcy case of instances where Debtor informed investors that it had bought and later sold securities for the investors' accounts. From this evidence, the Court concludes that Debtor has effected transactions in securities.

WesBanco next argues that because Debtor was never a licensed broker-dealer that it cannot be classified as a stockbroker for this matter. The Customer Creditors counter that the Code contains no requirement that an entity be licensed as a broker-dealer to be classified as a stockbroker under the stockbroker liquidation provisions. The Court finds no requirement in relevant law that a stockbroker must be licensed before the stockbroker liquidation sections apply.

WesBanco's final argument is that the Court should not apply the stockbroker liquidation sections because it

would be inequitable to do so. This argument is better taken up with Congress. The statute is clear - when the debtor is a stockbroker, the stockbroker liquidation sections apply.

This Court finds that Debtor is a stockbroker for purposes of the stockbroker liquidation sections. Debtor is a stockbroker as that term is defined in 11 U.S.C. § 101(54). There is no requirement that a stockbroker be licensed for the sections to apply. The Trustee, therefore, is instructed to distribute the assets of Debtor's estate according to the stockbroker liquidation provisions of Chapter 7 of the Bankruptcy Code.

IT IS SO ORDERED.

/s/
WILLIAM T. BODOH
UNITED STATES
BANKRUPTCY JUDGE

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Order was placed in the United States Mail this 31st day of October, 1994, addressed to:

CARL D. RAFOTH, ESQ., 40 North Phelps Street Youngstown, OH 44503.
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44113-1498.
DONALD M. ROBINER, United States Trustee, 113 St. Clair Avenue, N.E., Suite 200, Cleveland, OH 44114.

/s/
JOANNA M. ARMSTRONG